



SP Distribution and SP Manweb (SP Energy Networks)

**Response to Electricity Distribution Price Control Review
(Policy Consultation December 2008)**

Main Document

12th February 2009

(Response to specific questions in separate appendix)

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Introduction and Overview

ScottishPower Energy Networks (SPEN) welcomes the opportunity to respond to Ofgem's Electricity Distribution Price Control Review 5 (DPCR5), Policy consultation document (Ref 159/08).

The DPCR5 settlement needs to address two fundamental requirements that are driving the need for substantial investment in the industry in the UK:

- We need to continue the increase in asset replacement, begun in DPCR4, aimed at renewal of the UK's ageing Distribution infrastructure
- The Distribution companies have a significant role in facilitating European and UK Renewables policy delivery;

This review will mark a significant milestone, providing the platform for the UK to ensure security of supply, continue improvement in world-class customer service and underpin delivery of key environmental objectives. Given the scale of the investment and the challenges ahead it will be particularly important that this critical infrastructure investment is seen as an attractive opportunity, particularly as we will be competing for funds in a global downturn.

The main objective of Ofgem in setting the cost of capital is to facilitate the necessary capital formation (both debt and equity) to enable this investment to take place. This will be a challenging objective given current market conditions across the world, where unprecedented macroeconomic turmoil has impacted liquidity, reduced the markets appetite for risk and is demanding greater returns for taking risk.

More than has ever been the case since vesting it will be important to ensure that the Distribution Network Operators (DNOs) are seen as an attractive and secure investment proposition in a market that is likely to remain to have liquidity problems and where competition for infrastructure funding will be fierce. The combined plans of the DNOs, underwriting an additional 9000 jobs across the United Kingdom, will also have a significant role in helping the economy to recover from the current situation.

We would urge Ofgem to engage in the debate on cost of capital as early as possible in 2009 and to communicate their position well in advance of the final proposals more definitively than has been the case in the past.

Investing to preserve the safety and continuity of energy supplies

The industry has advanced capital investment plans that are consistent with the need to replace an ageing network and to reduce asset risk. While the scale of the increases are significant it is worth bearing in mind that companies will replace a relatively small proportion of their total asset base. In SPEN's case this will represent about 4% of the existing asset base. We continue to examine and deploy life extension techniques across our Networks and where possible review our operational procedures to ensure that we prudently replace assets. It is also important to note that companies' plans have had to increase to incorporate new legal and policy obligations introduced

since DPCR4 was concluded e.g. ESQCR Regulation 20A (compliance with ENATS 43-8 & ETR 132).

We support Ofgem's recognition that it is extremely difficult for the industry to anticipate the size, significance and timing of the consequences of environmental policies, and that there is a need for the DNOs role to grow to incorporate facilitation of these policies. Many of these factors will require a fundamental change to the regulatory framework, a process that can begin in DPCR5 but that we expect will also be addressed through the RPI-X at 20 project.

Against this backdrop of future uncertainty, Ofgem infer that unless DNOs second-guess the future correctly there is a real risk that a significant amount of the investment we propose will become unnecessary or redundant. This misrepresents the existing investment plans. As highlighted above companies are replacing a relatively small proportion of their assets, the vast majority of which will be required regardless of which future transpires. There may be a risk in future but at this stage it is relatively immaterial.

Locational charging impacts on investment

We are also concerned about the claimed potential impact of locational charging for EHV customers in reducing DNOs capital plans. We believe this has been overstated and that this does not demonstrate a clear understanding of DNO's EHV reinforcement requirements on the part of Ofgem.

Ofgem stated in their Structure of Charges paper that between 33% and 50% of load related spend in DPCR5 relates to EHV reinforcement, and assumes benefits of 5% of this (£100-125m). The majority of DNO's reinforcement needs, including EHV, are triggered by load changes at HV/LV, >96% of gross load related spend in SPEN for DPCR5¹.

Of the remaining 4% associated directly with EHV customers, these customers will actually fund the majority (c.75%) through their connections charges. It is therefore the connection charge that provides the economic signal both in terms of location and highlighting where the network has existing capacity at EHV. Applying SPEN's proportions to the industry forecasts and taking Ofgem's speculative assumption that 5% of EHV customer load related spend could be avoided would result in a potential saving of between £4-5 million for the total industry during DPCR5, against a request for investment of £7.7 billion across all DNOs.

¹ Extract from HLFBPQ August 2008

Role of the DNO in delivery of energy policy objectives

Distribution Network Operators (DNO) have a central role to play in the delivery of energy policy objectives. Delivery of these objectives will require Network companies to utilise different resources than they have needed to historically and to have better interfaces directly with the market, a factor that Regulation has prohibited and discouraged them from doing more recently.

The paper places a responsibility on the role of the Regulatory body that will be at the centre of this process, a fact that seems not to be readily recognised in the paper. It will not be sufficient to simply place all responsibility for delivery with industry. Ofgem will need to become an important facilitator in the process by development of a balanced, supportive and forward looking regulatory framework that better meets Ofgem's own reinforced environmental responsibilities as laid out in the Electricity Act 1989, as amended by the Energy Act 2008.

Weaknesses in existing mechanisms

Ofgem have identified a key weakness of the current DPCR4 settlement in their Return on Regulatory Equity analysis. Specifically that existing incentive mechanisms are not calibrated against the policy objectives that they set out to achieve.

For example, the uncertainty surrounding the losses incentive mechanism, where Ofgem have questioned the significant gains that some DNOs are receiving, yet to date Ofgem have made no attempt to measure actual underlying reductions in network technical losses and green house gas emissions achieved. In this instance there has been an over-reliance on data that does not necessarily correspond to a physical improvement in losses. In fact the data in question has proven to be volatile in a significant number of circumstances.

Ofgem's proposal to retain the DPCR4 losses mechanism, whilst approximately doubling its value and increasing the reporting and target setting volatility, is a major concern for customers, other stakeholders and DNOs and seems to contradict their efforts in other areas.

This contradiction can be seen in relation to investment where Ofgem are more specifically trying to tie down output measures against different types of investment that commit companies to demonstrating what customers receive (outputs) for investment (inputs) undertaken. This kind of approach that is matching inputs to auditable outputs if applied more generally will in itself bring about the proper calibration of incentive mechanisms. On losses, Ofgem remain to have failed to establish an adequate means of measurement for loss reduction arising from investments or initiatives undertaken by companies. Our experience has been such that without a fundamental review and overhaul of the Losses mechanism this item alone could make Ofgem's DPCR5 proposals unacceptable.

Proposals to fine-tune existing mechanisms

Elsewhere, we welcome many of Ofgem's other proposals to fine-tune DPCR4 incentive mechanisms (e.g. Quality of Supply and Customer Service) and to remove other mechanisms that have proved to be empirically flawed such as the existing volume driver for revenue. These decisions are balanced and in the long-term interests of customers but they also represent a recognition that there can be and is a need for longer-term consistency in how the regulatory framework operates.

Current Economic Outlook

There have been very sharp changes in economic conditions, the extent of which were not evident over the summer of 2008. The combined DNO investment plans, which will also bring a further new 9000 posts in engineering and crafts across the industry will not only now be about maintaining the integrity of the UK Distribution system but will represent a significant opportunity to help underpin the UK's economic recovery.

We are confident that we can demonstrate the need for this investment from an Asset Criticality perspective but Ofgem will have a key responsibility to ensure that we can attract investment and borrow from financial markets that are likely to remain turbulent and difficult in the early stages of DPCR5.

This price control review is of fundamental importance to our energy future, and whilst the policy document contains many excellent proposals, it is essential that a number of key weaknesses in the policy proposals be addressed to ensure that this Price Control Review is a success.

For SP Energy Networks, the key challenges raised in the policy document remain:

- Investing to preserve the safety and continuity of energy supplies and ensure that networks are sufficiently resilient to severe weather events;
- Ensuring that electricity network companies are able to continue to attract investment against a background where successive price reviews have significantly increased the risk borne by DNOs;
- Implementing a workable and balanced set of incentives aligned with energy policy objectives;
- Developing an effective and equitable framework that is in the interests of the end customer

We now consider the key objectives and themes raised before turning to detailed responses to the questions outlined by Ofgem in a separate appendix to this document.

2 Environmental issues - implementing a workable and balanced set of incentives aligned with energy policy objectives

2.1 DNOs as a low carbon facilitator - Future uncertainties

DNOs have a critical role in facilitation of a low carbon future in an uncertain environment. Between our commitment to research and design and our experience in connecting diverse sources of generation few companies are as well positioned as SPEN to meet the challenges ahead.

Ofgem recognise that at this point in time it is extremely difficult to anticipate the scale, significance and timing of the impact of developing environmental policies.

In anticipation of a future that requires the Distribution network to become more “active”, SPEN are involved in a range of industry-leading projects. We are working in partnership with world-class academic (e.g. University of Strathclyde, UMIST) and manufacturing bodies (e.g. ADB, Ariva) in the development of projects from multi-DG constraint management, to dynamic circuit ratings, to fault current limiters and energy storage. We have also proactively led the development of a UK network demonstration facility (£7m funding approved from Scottish Enterprise Nov 08), which will enable trialing and more effective roll out of future network technologies.

SP has also continued to successfully leverage significant external funding (fully leveraged programme is more than 7 times that obtained by SPEN through the IFI mechanism) to expand the limited scope of the DPCR4 research and development funding mechanisms. *We are surprised by the lack of recognition of some of these schemes within the document when they have been submitted as part of the IFI annual reporting scheme, and were warmly received by Ofgem.*

Given some of the challenges laid out regarding possible future configurations of UK networks and the need to innovate it is also surprising that the Technical Director’s role, which was a key enabler to the UK DNOs establishing the IFI scheme, has not been replaced. Particularly as it is exactly this type of engineering chairmanship that will be required to facilitate much of Ofgem’s policy paper.

Many of the challenges suggested by Ofgem are already here, our SP Manweb network is operating at a very high level of utilization with the complications of “churn” and continued pressure to connect distributed generation our Design team is balancing a toolkit of solutions, from adoption of operational schemes to ensure system security in a fully utilised network to developing smarter investment solutions.

Take for example the complex constraint management scheme to enable connection of Rhyl Flats (RWE Npower’s 87MW offshore wind farm), which monitors four different circuits to

provide constraining signals to the generator should overloads on the network occur. With the addition of dynamic rating this solution could be expanded to cover other generation in this part of North Wales.

Between our commitment to research and design and our experience in connecting diverse sources of generation few companies are as well positioned to meet the challenges ahead in balancing the network in diverse and uncertain environment.

Ofgem's expectations of DNOs have increased significantly. In this context it is important to recognize that there exists a tension between requirements to provide services in the most efficient manner, to create a competition in connections market solely based around price and to 'future proof' investments. Many plausible scenarios will require increased network capacities and investment in technology such as power electronics for control schemes, however these risk being deemed inefficient by Ofgem if DNOs were to install them at this time, whilst future requirements for additional capacity could result in Ofgem deeming current investments inefficient in retrospect.

Where there is a risk that investment may now be subject to significant uncertainty and political risk arising from decisions taken by the Regulator at a later date, this will only serve to deter investors and undermine confidence in the sector. Ofgem must be mindful that they do not create barriers to development through complex and uncertain economic schemes that are based around subjective reviews. In designing new incentives it is also important in our view that we do not undermine some of the key parameters of the existing model that have served well, for example the Regulatory Asset Value.

There is a need for a much closer degree of coordination in future in our view, this will require an active and participating Regulator that signs onto a shared vision of the UK's energy future that the DNOs can deliver against. This will in all likelihood involve revisiting some decisions previously taken by Ofgem that may seem politically difficult to them at this time.

2.2 Distributed Generation Incentive Mechanism (DGIM)

We agree with Ofgem's proposal to retain the DG Incentive Framework. However, we maintain that there is a case for the mechanism to be augmented to deal with very high cost project where network is sparse.

SPEN has connected approximately 2000 MWs across its three Networks, representing 34% of the total UK portfolio of Renewable Generation², and expect to connect another 250MW in the year to 31 March 2008. We interact with more than 25 different developers in facilitating connections to UK grid across CHP, Hydro, biofuels and wind sources.

² Renewable generators connected to SPEN network at April 08 as a percentage of portfolio quoted in Digest of UK Energy Statistics (DUKES), 31 July 08

In our previous response we highlighted that the low levels of megawatts connected across the UK is directly attributable to the complexities of obtaining planning consents and land rights, and to the structure of incentives faced by the GB Transmission System Operator (GBSO) under the current regime, and does not relate to the DGIM or the DG connections issues identified.

While Planning remains a key concern, since our last submission:

We remain concerned that DG connections may not be permitted to connect schemes that, whilst they do not trigger any local transmission works are seen to be a contributing factor to the rising cost of constraints on the wider transmission network.

Whilst NGET's CAP167 proposals have the potential to severely limit the connection of renewable generation in Scotland, we note the lack of support they have received from the industry as a whole. In comparison, the CE/ENW alternative amendment focuses on those transmission system works actually triggered by the connecting party. ***This alternative amendment has received much wider support from both within the CAP167 Working Group and the CUSC Panel.***

The CAP167 amendment proposals currently sit with Ofgem for approval and it is critical to the future of Distributed Generation in Scotland that Ofgem do not approve the NGET proposal.

National Grid recently issued an updated GB Queue Management Methodology that now gives DG schemes the ability and right to request advancement. We are also encouraged by the work being done by the three Transmission companies, as part of GB Queue Management, to advance the connection dates of a number of projects. We are however concerned how such DG schemes will be treated under the enduring TAR arrangements. The TAR CUSC amendments focus on CUSC generation parties who have access rights to the Transmission system, and while it is assumed that arrangements for smaller embedded generators will continue to be managed by the Statement of Works process, it may lead to small generators having to apply for explicit rights with stronger obligations placed upon them as a result.

It is also of concern that Ofgem have publicly stated they are unlikely to approve National Grid's four-year connection date advance for 450MW of renewable projects in Scotland, stating that the associated extra constraint costs would be unacceptable³. This conflicts directly with the messages from Ofgem to date and while we accept there will inevitably be short-term issues around about consents these should be resolved by the steady progress of the infrastructure upgrades that are taking place and are planned to take place across the GB grid.

Regarding the DGIM itself, we believe that it provides an effective framework to enable DNOs to co-ordinate with multiple generator parties to provide more efficient and speedy

³ SRF Conference, Glasgow, 27th February 2009

shared connections. Within the current framework we have several real examples where we have liaised with developers to deliver more efficient and 'consentable' infrastructure and connection solutions.

We also believe that the volume of schemes completed to date do not provide a sufficient statistical data set to justify material revision to the DG mechanism funding rates, although there is some evidence that differential rates for different voltage levels may be appropriate. We believe there is case for lowering the high cost project threshold from £200/kW for non-sole use infrastructure.

In our last submission we highlighted that our experience has shown that the existing DGIM does not work in certain areas where there is little or no existing infrastructure to accommodate connection of Renewable Generation, the example we cited was in Wales where the Welsh Assembly has laid out its TAN 8 proposals. **We therefore also maintain that there remains a case for augmenting the DGIM mechanism to deal with very high cost strategic infrastructure projects. Such projects can be identified statistically and a threshold established, that when exceeded (assuming projects pass normal tests of efficiency) allow for a higher £/MW assumption within the DGIM mechanism.**

2.2.1 Information

We agree with the principle of provision of additional network information to prospective generators, however it must be recognised that this will require DNOs to introduce a new customer interface, which will require to be adequately funded.

Whilst we agree that there is additional information that can be provided to prospective generators, the solutions implemented need to be useful to generators, cost effective and proportionate.

Provision of some of the information detailed in Ofgem's proposal does not recognise the complexity of network analysis, or the scale of the step change that may be required from DNOs current practices, for example in relation to scale, complexity, frequency and presentation of results of 11kV network modeling.

We welcome Ofgem's recognition that an indicative web-based connection-costing tool will require efficient costs to be funded, and would expect that this would also apply wherever incremental costs will be incurred as a consequence of Ofgem's proposals.

2.2.2 UoS charges

In order to meet energy policy targets we believe that generator use of system charges should reflect the network benefits that they may bring and should not exceed a maximum cap of zero.

The reason for our recent decision

SPEN took the decision to object to the recent CLM because it imposed a requirement for DNOs to implement a particular Long Run Incremental Cost (LRIC) methodology for our EHV (33kV and above) customers. We believe that implementation of this methodology would be detrimental to some of our most significant demand and generation customers connected at EHV, resulting in inappropriate and excessive charges and in a number of circumstances leading to even more severe consequences for these businesses in the current economic climate.

A typical example of the problems created by the proposal from Ofgem that we encountered is that of a pharmaceuticals manufacturing facility within our franchise area, which is a major employer in a relatively rural location. This customer has been connected to a highly loaded but low/negative growth part of the network for many years. Under Ofgem's proposals this customer faces a potential 12 times increase in use of system charges associated with network reinforcement which is not forecast to be required many years, if at all.

There would have been similar impacts for EHV connected generators in rural areas where the network is predominantly utilised by generation. These issues would be of concern at any time, but will be of increased concern for customers given the current economic climate and government targets for renewables.

In order to meet energy policy target we believe that generator use of system charges should reflect the network benefits that they may bring and should not exceed a maximum cap of zero. However, a more simple and transparent alternative would be to set all generator UoS charges to zero.

We are working with the DNO Structure of Charges project to deliver charges that reflect network benefits for HV and LV generators.

Any financial recognition of generators network benefits will require a combined allowed revenue for demand and generation customers (single pot), this will be required for 1 April 2010 if DNOs plans for common HV/LV charging methodologies are not delayed by a Competition Commission referral.

Jointly with SSE, we have proposed a pragmatic means of progressing the issues outlined above and have responded to a further information request from Ofgem which should help take some of these issues forward.

2.2.3 Treatment of pre 2005 generators

Pre 2005 generators should also benefit from negative charges that reflect the network benefits that they may bring.

There will be an administrative burden on DNOs if pre-2005 generators were to be exposed to positive UoS charges, due to the connections charges refunds that may be necessary. A similar exercise for Scottish transmission connected customers at BETTA go-live demonstrated the considerable complexities and administrative burden that this could entail.

A policy decision to cap generator use of system charges to a maximum of zero, or the simpler solution of setting all generator charges to zero, could perhaps avoid the significant burden of harmonization of all generator connection boundaries.

2.3 Innovation and future networks

The role of DNOs needs to develop significantly beyond that facilitated by previous price controls, a robust framework from Ofgem is essential to enable this.

2.3.1 Opex capex

We agree that it is important that innovative solutions are not constrained by the different treatment of opex and capex

In principle, we support equalisation of incentives for opex and capex, otherwise, there is an incentive to distort expenditure decisions and potentially constrain innovative solutions.

Our preferred approach would be to equalise the proportion of cost-savings retained, for both opex and capex, by an adjustment at the beginning of the next price control period, similar to the capex mechanism for DPCR4.

Simply fixing the boundaries between opex and capex is not sufficient to equalise incentives, as the proportion of cost-savings retained would continue to be different.

2.3.2 IFI

The IFI mechanism has been a resounding success against which companies such as SPEN have levered further funding. It is by building on the platform that IFI provides that we believe we can prepare DNOs for the future.

With the support of the Technical Director at Ofgem, it was the DNOs who drove the need to reintroduce research and design work that had been previously stifled by shortsighted regulatory economics. The IFI mechanism has been a resounding success against which companies such as SPEN have levered further funding to develop and implement technologies with mid range Technology Readiness Levels (TRLs). It is by building on the platform that IFI provides that we believe we can prepare DNOs for the future that lies ahead.

We see merit in the mechanism being expanded to include the early stage deployment of technologies that have been developed through IFI mechanism, specifically applied to more expensive Technology Readiness Levels 8-9, Application of IFI (AIFI).

We propose that that an AIFI mechanism should encompass:

- **Further 0.5% of revenue specifically targeted for higher TRLs**
- **Projects linked to previous IFI work by any DNO**
- **No-regrets funding**
- **Deployment of the same technology across all DNOs should be promoted where critical mass is important, rather than prohibited**

We do not believe that simply providing greater availability of funding to DNOs will achieve a change of behaviour, whilst a new extended targeted mechanism as we have described will deliver new technologies across the industry.

For example, high capital cost technologies that are almost at commercial application, such as energy storage, are prohibitively expensive under the existing IFI mechanism, as they would utilise much of a DNOs allowance. By introducing an AIFI scheme as described, DNOs as a group would be able to move forward technologies through early stage development and begin to reduce the capital costs of the technology.

2.3.3 Innovation and future networks

It is essential that Ofgems proposals are well defined to enable DNOs to respond to current uncertainties at the appropriate time, and do not penalise companies that make decisions based on the available information at the time.

It is widely recognised that the facilitation of a low carbon electricity system will require radical changes on both the supply (high penetration of variable renewable generation resources at all voltages) and the demand side (energy efficiency and the potential electrification of heat and transport). As the network operator is the common link between these changing inputs/outputs it is recognised that there will need to be an evolutionary change in both network topology and network operation from the largely passive (fit-and-forget) system of today.

We firmly believe that low carbon generation connecting to both the transmission and distribution networks is required in order to move in the direction of the EU CO2 targets in both the 2020 and 2050 timeframes.

The DPCR5 period therefore has a fundamental role in laying down the foundation of a regulatory framework that will allow us to meet the targets that apply for the end of DPCR6.

There is uncertainty about the choice and costs of the solutions that will be used to make the network more flexible and controllable, this being related to the availability of solutions and their positioning in the Research & Development (R&D) lifecycle. Whilst excellent, and in some cases world leading, work is being achieved via the Innovation Funding Incentive, there is a natural lag in delivery of complex technology to the networks. **Ofgem should recognise that all DNOs have effectively ramped up R&D from a point of almost zero in 2005 to today's level (leveraged programme in excess of £35m)⁴.** Even without 19 years of RPI-X pressures and its affects on engineering resource in the UK, there would be a natural delay in the delivery of innovative solutions to the network moving from such a low starting point. It is accepted fact that network related R&D has longer timescales in comparison to many other sectors (e.g. pharmaceuticals, vehicles, mobile phones, etc), where their end product life-expectancy and competition (directly linked to market share) are on a different scale to that of DNOs.

We recognise, through projects in our own IFI portfolio, that many of the concepts and technologies underpinning a change to a more flexible network are still very much in an embryonic stage, with little or no firm commercial offerings in the marketplace. Examples here include Active Network Management (ANM) functions⁵ such as dynamic load management, multi-generation constraint management, fault current limitation, etc. However, uncertainty around the costs and choices of solutions and the inability to benchmark against other schemes in detail should not, in itself, become a reason for delaying investment in these enabling technologies. In order to avoid such behaviour a 'no-regrets' approach to specific and targeted expenditure to such projects would be of benefit.

Furthermore, we recognise that overcoming the technical barriers with a 'product' is only part of the challenge, and having proven a technology there may be commercial or Regulatory issues that need to be resolved prior to wide-scale adoption. A good example here is energy storage, that whilst technically available in a variety of forms Li-On, NaS, Lead-acid, etc) suffers from both a high capital cost and challenges the current Regulatory position for a network operator to own what could be perceived to be a generation technology. We have given some consideration to commercial barriers (Appendix Ch 2 Q5) and would welcome the continuing engagement and support of Ofgem for Regulatory matters as they arise.

It is increasingly apparent that a wider form of cross sector participation is required to facilitate the paradigm shift to a low carbon energy system. We would acknowledge that working as an individual DNO, or even body of network operators is insufficient to develop a future network in the most economic and 'future-proofed' manner. **Feedback given as part of our stakeholder engagement highlighted the need for active engagement with suppliers (re. smart metering), generators (re. energy mix), planning authorities (re. geographic issues) and other key stakeholders (e.g. car manufacturers – re. Plug In**

⁴ This includes c.£10m of other DNOs IFI funding

⁵ It is our understanding that an all-encompassing SmartGrid, utilising many of the Active Network Management techniques and technologies in addition to devices like smart meters, etc.

Hybrid Electric Vehicles) in order to fully understand the risks and opportunities presented by changes outside of the current Networks arena.

It is questionable whether or not DNOs will lead these developments or actually have to respond and facilitate their development. Consider electric cars where a response to market demands will be led by car manufacturers and DNOs may have to provide infrastructure to support this. We believe that appropriate cross industry forums need to be established to enable any developments to move forward in an effective and co-ordinated manner. Ofgem could have a key role in helping facilitate this in conjunction with DECC.

It is also fundamental that to meet these challenge DNOs need to be appropriately resourced to engage directly with customers, other industry parties and policy makers.

Ofgem will be also be required to ensure that concerns around aspects of business separation (between network operators, suppliers/generators, Meter Operators for example) and industry structure do not become a barrier to tackling these issues.

2.3.4 Treatment of transmission exit charges

Transmission exit charges are unsuitable for incentivisation

The main driver for changes in transmission exit charges is replacement of life expired assets. Transmission owners are entering a period of increasing asset replacements, with many connection assets currently fully depreciated and not attracting annuitised capital charges.

DNOs will face significant increases in charges going forward, and historic charges cannot be utilised to establish a baseline charge.

Areas of the country that are particularly rich in renewable resources will also face relatively greater increases in transmission exit charges.

This will be further compounded in Scotland as a consequence of the differences in transmission network voltage levels, both in terms of the relative volatility and the numbers of connections to the transmission network in the South of Scotland being approximately 5 times that of a typical England and Wales DNO.

There is little impact that DNOs can have on the transmission exit charges that they face.

2.4 Reducing the DNO's environmental impact

2.4.1 Losses

DNOs have a significant role to play in reducing green house gas (GHG) emissions, however the DPCR4 losses incentive mechanism does not facilitate this role and requires to be replaced.

Ofgem have correctly identified network technical losses as the single most important area in terms of carbon footprint for DNOs, particularly as our industry moves into a period of continued and intense asset replacement. **Ofgem's Return on Equity analysis shows a number of DNOs deriving benefits from the DPCR4 mechanism that exceed by many multiples the technical loss reductions that a DNO can have physically delivered.** It is of great concern that Ofgem's current proposal for DPCR5 involves a revision of the existing scheme to introduce greater volatility in target setting and reporting whilst increasing the incentive rate significantly.

While we believe that there is a material opportunity to achieve a reduction in GHG, the current mechanism does not provide the appropriate framework to achieve this because it does not provide adequate signals to DNOs to invest in either low loss technology or loss reducing initiatives, it does not extend to deal with other market participants such as IDNOs and it cannot be accurately observed and measured as an output because of underlying volatility in the Settlements system.

We believe that one of the barriers to Ofgem changing their view regarding this mechanism is an apparent lack of engineering understanding and the impact that DNOs can directly have on network losses. **We therefore believe that in addition to the existing economics team there needs to be independent engineering input to the development of this incentive mechanism.**

We understand the point made in paragraph 2.89, and accept that EDF has made significant headway in terms of reducing commercial losses but the ScottishPower Group could demonstrate likewise and possibly at an earlier date, we suspect that there are other groups that have also been similarly active.

SPEN has been the only company to be significantly penalised by the Losses mechanism as the result of Ofgem revising our losses targets after the conclusion of DPCR4. This was as a direct result of underlying volatility in data utilised in the current mechanism and a move toward targets based on shorter terms and not because of reporting methodologies. The current proposal will lead to other companies being similarly penalised. Our experience has been such that without fundamental review and overhaul of the Losses mechanism this item alone could make Ofgem's DPCR5 proposals unacceptable.

In light of our experience we can see no alternative to a hybrid approach to losses: involving a “quasi output” approach to technical losses and a separate targeted mechanism for commercial losses with a much lower incentive rate. Applying this approach can provide much greater certainty of environmental benefits for customers in relation to technical loss reduction initiatives, and is much more an output measure than the current scheme.

The DNO proposal contained in the document (for which we have presented a variant) would represent a significant advancement on the existing scheme. In our view this would also be more robust and directly auditable than the CERTS scheme for Suppliers, which is administrated by Ofgem, and would yield real environmental benefits, which are a matter of physical fact.

Smart meter rollout

It is unfortunate that the smart meter roll out to domestic customers is unlikely to deliver full customer penetration for many years (current expectations are 2019) as this would significantly increase the confidence in reporting and settlement system outputs.

Universal smart meter rollout would enable the existing estimated losses incentive mechanism to increase in accuracy so that reported losses may become a reasonable proxy for measured network losses, this might enable a proxy measured losses incentive regime similar to that in DPCR4 to be reintroduced.

The phased roll out of smart meters, beginning in earnest during DPCR5, will result in significant short term settlement system volatility, and possibly require a resetting of losses targets.

Metering in secondary substations

If the problems and costs identified surrounding customer outages can be addressed, technology trials are currently being considered, then the proposal to install a meter or equivalent monitoring equipment in every secondary substation merits further investigation.

This could enable DNOs to focus load management initiatives on secondary substations with high loading, and to measure losses on the EHV/HV network. However, the main component of most DNOs loss reduction plans, low loss primary transformers, would gain little from such an initiative.

Further, it may allow DNOs to derive greater benefits from the rollout of smart meters to all customers, and begin to prepare for active network management due to widespread microgeneration. For example, in conjunction with Smart Meters this could allow DNOs to identify high loss / theft areas of the network and focus corrective activities accordingly.

2.4.2 Sulphur Hexafluoride (SF6)

We support Ofgems view that an incentive mechanism is not appropriate due to the design of SF6 equipment used by DNOs

2.4.3 DNO business carbon footprint

We support Ofgem's proposal that DNOs should publish their annual carbon footprint, the relative annual improvement and the principles of their reporting methodology. However, we believe that the reporting scope proposed by Ofgem is inappropriate.

Ofgem have correctly recognised the relatively low impact of DNOs carbon footprint excluding network losses, and that the cost of reporting of this should not outweigh the benefits.

There is merit in the proposal for each DNO to report its relative annual movement in its own carbon footprint, as this deals with differences in reporting period, reporting methodologies, and differences in business management (insourcing vs outsourcing) and differences as a consequence of the geographic location of DNOs.

However, we do not believe that the proposals to report using a standard methodology, for a regulatory year including contractors, satisfies the test of reporting costs being outweighed by benefits.

We believe the objective of this policy decision could equally be met by publication of each DNOs existing footprint reporting methodology, reporting being related to whichever period the DNO already reports this (calendar or regulatory year), plus a short report of material changes in business practice that might cause a step change from one year to the next (e.g. outsourcing of an activity).

2.4.4 Undergrounding in AONB and National Parks

The AONB mechanism for undergrounding overhead lines in Areas of Outstanding Natural Beauty has been a success. The Regulatory definition of AONB should be refined to recognise the Scottish National Scenic Area designation.

The AONB funding mechanism during DPCR5 is enabling us to successfully address a number of stakeholder visual amenity concerns within Snowdonia National Park.

However, **the current definition of AONB requires to be extended to capture differing status of areas of environmental sensitivity in Scotland.** The current definition of AONB is preventing us addressing a number of stakeholder visual amenity concerns within the South of Scotland.

AONB is an England and Wales designation and is not used in Scotland. The National Park designation, while different in detailed aims between England, Wales and Scotland, has the same broad aims. Differences between the England and Wales AONB designation and the Scottish National Scenic Area designation resulting in areas of the Scottish Landscape, designated for its landscape quality and amenity value, not being appropriately considered by the blanket use of the AONB terminology.

2.4.5 Fluid filled cables

We support the adoption of a standard risk based approach across the industry to prioritise replacement of fluid filled cables or other management techniques.

3 Customers - developing an effective and equitable framework that is in the interests of the end customer

3.1 Customers Priorities

It is important that the DPCR5 settlement is in the long-term interests of the end customer.

The findings of Ofgem's customer survey that the most important issues for customers are network resilience, effective communication in outage situations and environmental initiatives are consistent with the results of our own extensive stakeholder engagement.

Regarding Ofgem's willingness to pay survey, the finding that customers have a lower willingness to pay than at DPCR4 is an understandable response in the current economic climate, and can be reflected by revision to incentive rates.

3.2 Wider Communication Customers

We support Ofgem's proposals to introduce a broad measure of customer satisfaction, providing it is relevant, cost effective and provides timely feedback to DNOs.

We welcome the proposal to introduce a broad measure of customer satisfaction. It is important that this focuses on aspects of service that are the responsibility of the DNO and that we can directly influence.

For example, we are advised by developers that they are confused by the complexity of the electricity market and that they do not understand the need for multiple parties to be involved in a new connection, for example an ICP, DNO, Supplier and Meter Operator. This is a function of the market structure and out-with the control of the DNO.

We support Ofgem's proposal to progress this in two phases namely, changes to the existing telephony scheme and the introduction of a broader measure of customer satisfaction to replace the current telephony incentive scheme during DPCR5.

We have some reservations regarding the applicability of an advocacy-based approach to DNO's since:

- DNO's are essentially monopoly businesses and customers have little real ability to either choose or recommend their DNO to a friend
- It is not clear that customers will understand the complex market segregation (MOPS, distribution, billing etc) and their responses may be influenced by their wider experience, not just the experience in relation to the DNO.
- An advocacy approach takes away any option other than 'excellent' service by removing any grading scale and replacing it with a 'yes' and 'no' response.

However we are open to a thorough consideration of the merits of such an approach. We understand Ofgem intend to employ Market Research experts in this area but would emphasise that it would be beneficial to use a firm that has worked in this area before. We would also envisage that the DNOs would have a strong role in helping to develop a terms of reference for their work.

Providing the responsibility for initiation of the existing telephony survey is successfully transferred from Ofgem to DNO's then we see no reason why implementation of the broader customer satisfaction measure cannot be implemented in a similar manner.

With regard to the detailed development and implementation of this measure we believe the most appropriate way forward would be for Ofgem to implement a working group comprising customer service experts from each of the DNO's and Ofgem with the objective of developing a broader measure of customer satisfaction and implementing a trial survey from 1st April 2011.

3.3 Connections

The existing framework needs a fundamental review and overhaul to stimulate competition in DNO areas where effective competition has yet to develop, and to address weaknesses in the current arrangements.

We encourage the fresh thinking in the document on how to stimulate competition and enhance customer protection in relation to electricity connections, and to improve competition in connections reporting.

Ofgem quote the 2007/8 Competition in Connections review that clearly demonstrates SPEN delivering industry leading levels of competition in both SP Manweb and SP Distribution areas despite the inherent lag in the current reporting system, and the reporting incorrectly including service alterations for 2007/08.⁶

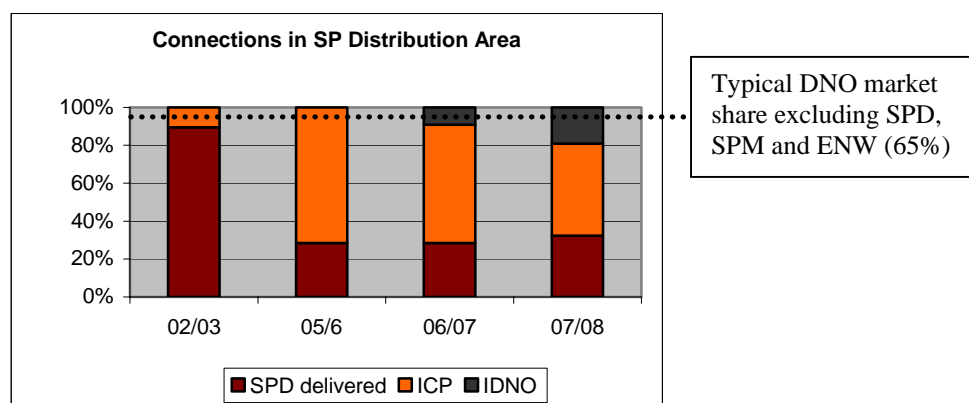


Chart 1: Market shares of new connections in SPD area⁷.

⁶ Table 8, Appendix 7, page 61 of DPCR Policy Paper supplementary appendices

⁷ excluding service alterations and including out of area DNOs

Whilst Ofgem's annual reporting is based on customer end connections, connections that have been contractually won by IDNOs are much more relevant. The chart below shows live IDNO networks that will supply in excess of 40,000 customers once the developments are complete.

Ofgem's 2007/8 Competition in Connections review also shows more IDNO networks in SPD areas than the rest of the UK.

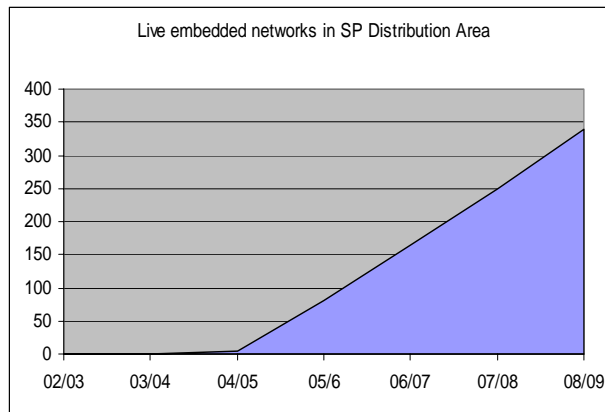


Chart 2: Growth of IDNO networks in SPD area.

We can see the attraction of applying performance standards in sectors of the connections market that do not currently attract competition.

However, it should be recognised that there are already Guaranteed Standards for timescales for providing connection quotations at LV (up to four premises). Where customers do have problems there are new Complaints Handling arrangements established by each DNO as a result of the CEAR Act of 2007, supported by an independent Energy Ombudsman, that enhance customer protection in this area.

There is strong evidence that customers for one-off and other small connections are generally satisfied with the service provided. By way of illustration, SP Distribution alone carries out some 20,000 connections a year, while in the last 12 months that the consumer watchdog energywatch was in existence (up to September 2008) complaints received by energywatch in relation to SP Distribution across all categories totalled 6.

The proposals in relation to profit margins for sectors where there is judged to be actual or potential effective competition are imaginative. However, the DNO may have difficulty in achieving a margin in such cases, and there is also the question of how high the competitiveness 'bar' will be. SPEN has argued for some time that published figures in the annual 'CIR' report understate the extent of competition, for example by failing to take into account trends for accepted quotations versus final connections actually carried out.

We do not support price caps for 'non-competitive' connections due to the individual nature of even 'minor' connections. We apply individual assessment to all new metered connections

due to the large number of parameters involved, such as ground type, distance from the network, capacity required, costs of obtaining land rights etc.

We are surprised that there is no real analysis in the paper of the competitive framework as it relates to the construction and operation of IDNO networks. There is no discussion, for example, of the role of adoption payments. Given the rapid growth of IDNO sites, this is an important omission in the consideration of options for encouraging competition.

As a Group we are committed to competition in connections provided it is on a level playing field and that the end consumer genuinely benefits in terms of quality and value of service.

We believe that competition in connections in areas where there is effective competition from Independent Connections Providers (ICPs) has yielded material benefits and savings for developers, but there is no evidence of benefits for end customers in terms of cost or longer-term levels of service.

There is no evidence that the introduction of Independent Distribution Network Operators (IDNOs), and specifically the skewed regulatory arrangement which favours IDNOs, has delivered material benefits or savings for customers under the existing framework and we strongly believe that this is an area of activity that needs a fundamental review and overhaul.

Whilst there is insufficient evidence to date of the impact of market segmentation and network nesting on issues such as long term customer service levels, there is clear technical evidence that a short term focus on connections cost has lead IDNOs to install networks that are inappropriate from an environmental perspective (specifically increased network losses).

We also note that the current IDNO regulatory arrangements are inconsistent with Ofgem's stated desire in the DPCR5 Policy Consultation for future proofed development of networks with an emphasis on environmental initiatives.

We are also concerned by the inequities that exist in the current regulatory framework where provision of licensed connections must be carried out at cost, failing to recompense shareholders for the significant opportunity cost entailed in the physical and financial resources employed.

Ofgem's proposal to introduce a regulated return on connections activities for all DNOs in order to stimulate competition in connections will have a greater impact in areas where competition is already effective.

Ofgem's proposal for unregulated returns in DNO areas where there is effective competition, such as the SP Distribution and Manweb areas and will merely lead to greater market penetration by IDNOs and ICPs.

SP Energy Networks has actively engaged in facilitating competition in connections within our franchise areas. We are able to point to a level of competition in both our franchise areas

(SP Manweb and SP Distribution) that is consistent with the level of competition in independent gas connections.

We propose that Ofgem should make the following changes to the regulatory arrangements for new connections:

- Ofgem should initiate a fundamental review of the IDNO regulatory framework to establish why there is effective competition in some areas and not others;

In areas where there is effective competition:

- DNOs can earn a regulated margin on contestable activities. This will address one of the flaws of the current arrangements and encourage DNOs to stimulate competition in their areas.
- New connections taken by the DNOs should attract the similar level of incremental revenue as an IDNO would be allowed (in effect a revenue driver)
- DNOs can offer asset values to developers / ICPs in a similar manner as IDNOs.

We believe that these measures strike an appropriate balance of encouraging competition in DNO areas where this has been slow to develop, and beginning to address some of the inappropriate market arrangements in areas where competition has fully developed.

3.4 Guaranteed Standards of Performance

The existing Guaranteed Standards mechanism strength and scope are correct. Overall exposure requires to be explicitly capped during normal weather conditions and one-off exceptional events.

We welcome Ofgem's acknowledgement that the strength and scope of the current standards are adequate and we support the increase in GS payments in line with inflation.

We believe there must be an explicit cap on the exposure of a DNO to Guaranteed Standard payments during normal weather conditions and one-off Exceptional Events. This could be achieved by placing an upper limit on the payments to any individual customer to say £200. Ofgem have not made any adequate proposals in the Dec 08 paper to address this concern.

3.5 Customer Service Reward (CSR) Scheme

The CSR scheme should be extended in scope rather than refocused.

We support the customer service reward scheme. We recognise that the new categories proposed for the scheme represent important groups of customers who may not otherwise benefit from DNO licence requirements or responses to incentives.

It is not clear what criteria would apply in the assessment of submissions against the new categories. These need to be considered alongside any changes to the existing categories.

As regards the proposed category of ‘communication with worst-served customers’ it is important to take into account whether (and how) a new incentive or allowance is introduced to address this group of customers, as discussed in appendix 7 of the paper.

CSR should be open to recognise all novel or innovative customer service initiatives that are not explicitly identified in our Licence

We do not support either of Ofgem’s proposals with regard to universally requiring DNO’s to adopt best practice since:-

- not all best practice initiatives will be suitable for all DNO’s as they may not ‘fit’ with all DNO’s existing processes and procedures.
- adoption of best practice as a minimum requirement for future participation in the Customer service reward scheme will discourage future participation.

Ofgem should continue to publish the details of initiatives that receive rewards and/or commendation during a DPCR to enable other DNO’s to select those initiatives that best fit their own operations and would thus have a positive impact on the customer care they are able to provide.

Companies that chose not to adopt the identified ‘best practice’ would be required to provide an explanation of why that was the case.

3.6 Quality of Service Interruptions Incentive Scheme (IIS)

The existing IIP customer service mechanisms are broadly correct but require to be retuned to resolve identified weaknesses. Ofgem's proposals will begin to address the wide variation on incentive rates which does not value customers equally and can be unfair for companies at or near the frontier as measured by Customer Interruptions.

We support the majority of Ofgem's proposed improvements for the IIS scheme for DPCR5.

The RORE analysis performed by Ofgem demonstrated that the power of the IIS incentive mechanism was appropriate. Comparisons with other current flawed incentive mechanisms, such as losses are inappropriate.

The national exposure to IIS should be retained at a level equivalent to 3% of total national revenue but this should be re-spread across DNO's based upon a fixed percentage of Operating costs.

We support a review of incentive rates such that a single customer interruption and customer hour supply lost have a consistent value across the UK such that the bandwidth around targets for max penalty / reward is variable across DNO's.

We believe that this can best be achieved by:

- Fixing a national value for a single customer interruption and customer hour supply lost to a value linked to the long-term customer willingness to pay
- Exposing a fixed percentage of Operating Costs to the IIS, this percentage of Operating Costs should be set such that the national value exposed to IIS incentives is broadly equivalent to the current 3% of total revenue. This approach ensures that all DNO's have a similar risk exposure to the IIS mechanism whilst removing the non-linear impact of financial assumptions regarding depreciation of a DNO's asset base.

We support the two key changes that Ofgem have adopted for the calculation of IIS targets for unplanned system performance, namely recognising that with current investment plans there is little opportunity for DNO's to massively change the failure rates of underground cables and that CML targets should be calculate using CI benchmark values.

Potential benefits that could be realised by the setting of longer-term targets are outweighed by the limitations and approximations in the current target setting methodology and the benefits of regular refinement of the mechanism. We therefore do not support the proposal to set longer term targets as part of DPCR5.

We recognise Ofgem's real concerns regarding the accuracy of Pre-arranged CI/CML allowances, but these concerns will not be avoided by moving to Capex/Opex allowances. Our preferred approach is to retain the current mechanism and for DNO's to be required to

demonstrate to Ofgem how their estimates of future Pre-arranged CI/CML are linked to their proposed work programme.

Excluding Exceptional Events (EEs) from IIS is essential to ensure that the mechanism does not become a weather lottery. To ensure consistency of operation of the IIS it is essential that any comparison between actual performance and targets be made on a consistent basis. If any changes are made to how EE's are excluded then it is imperative that targets are recalculated, by applying the revised EE processes to historic events.

We believe that there is benefit in terms of consistency in retaining the current methodology for weather related events in DPCR5 but support the exclusion to of all faults that occur during the EE period and not simply those that are weather related.

In all cases it would be necessary to apply any revised EE criteria to historic data before using the historic data to set future targets.

By exclusively focusing on events outside the control of the DNO, the one off EE exclusion process fails to acknowledge that even the most prudent DNO is exposed to the risk of big IIS impact events, for example during outages on higher voltage networks. We would therefore propose that the one-off EE mechanism is extended to include a limited number of events within the control of a DNO.

3.7 Worst Served Customers

We support the focus on worst served customers but are concerned that the current proposals will not address the very worst served customers.

We support the focus on worst served customers, consistent with our submissions for DPCR4, our response to the Initial Consultation and our HLFBPQ submission.

Our stakeholder consultation demonstrated universal agreement that worst served customers should be addressed.

We are pleased that Ofgem are proposing to set a Capex allowance for each DNO to direct towards improvements for WSC. We would prefer to see the allowance set closer to our Aug 08 submission level, of £8m for each of our licences, however we agree that any allowance is a significant step forward from DPCR4 and we believe we could deliver a reduced but effective program of improvements for the c£3m allowance per DNO considered in Ofgem's documents.

Ofgem should not set an upper threshold for the allowed investment aimed at improving the service for a worst served customer since this will effectively result in some WSC being deemed too expensive to address. We would prefer for Ofgem to require DNO's to use the allowance to ensure that it is spent effectively to deliver the best service improvements for their worst served customers.

4 Networks - investing to preserve the safety and continuity of energy supplies and ensure that networks are sufficiently resilient to severe weather events

4.1 Nature of Price Control Settlement and Behaviors

The behaviours outlined by Ofgem should include an active role in development and facilitation of energy policies.

The broad “behaviours” that are set out in the Policy Paper are consistent with the key components of our Asset Strategy that has been accredited under the PAS 55 scheme. We believe that the list should also include the behaviour: ‘to take an active role in development and facilitation of energy policy’.

4.2 Performance against DPCR4 settlement

We agree that Companies should not benefit fully from capex underspend through the IQI mechanism unless they can demonstrate that matching efficiencies have been delivered.

Every Company will establish an investment plan that it works to and that underpins its budgeting process. This is fundamental to planning funding arrangements. After a negotiation that takes up to 24-months the allowances Ofgem set become that plan and budget for the DNOs. These plans are underpinned by detailed Asset Risk data and engineering assessment produced at the time with the best knowledge available. During DPCR4 SPEN has had to respond to the substantial unanticipated real increases (above RPI) in equipment and other input costs by delivering capital efficiencies, improving our Asset Risk processes and prioritising its capital expenditure.

We agree that Companies should not benefit fully from capex under-spend through the IQI mechanism unless they can demonstrate that matching efficiencies have been delivered.

However, Ofgem’s simple expectation that network risk that may have built up as a result of deferred asset replacement in order to avoid an overspend, 20-40% of the value of which should be funded by shareholders, is wholly unreasonable.

This has served to protect customers from substantial real input price rises, and any impact on network performance is dealt with by the IIS incentive scheme.

Customers have therefore benefited from avoided overspend, and this clearly merits a different treatment from a scenario where companies have deliberately not utilised the investment available to them, including funding by customers of efficient levels of catch up.

4.3 DPCR5 Forecasts

Increased DNO forecasts reflect the increasing burden of managing ageing networks and new obligations.

Network investment

Significant proportions of our networks are reaching the end of their assumed operational life during the DPCR5 period. Our DPCR5 submissions reflect efficient and effective asset management techniques to optimise the effect of our planned investments.

Plans for DPCR5 include new mandatory obligations, and assets such as rising mains that were not part of the scope of DPCR4. It is important to consider these factors when assessing the forecast rise in capital expenditure.

Given the current macro-economic uncertainties revenue drivers are clearly appropriate for elements of load related investment.

Network operating costs

It has been clearly demonstrated during DPCR4, by DNOs performance against operating cost allowances, that operating cost allowances set on the basis of a simplistic annual efficiency stretch are no longer appropriate for the regulatory mature DNOs.

Further, the continuance of such a mechanism is entirely inconsistent with Ofgem's stated expectations of a much-changed role for DNOs in DPCR5, which will require different resources and increase costs.

4.3.1 Managing uncertainty / Risk Sharing

Volume Uncertainty

We agree with the removal of the current revenue drivers based on units distributed and customer numbers. In DPCR 4, the current growth term resulted in a significant shortfall of allowed revenue for SPD and SPM and had no reciprocal reduction in our cash costs. Furthermore, the continued use of units distributed would be inconsistent with the transition to a low carbon economy.

However, we do support the development of more appropriate revenue drivers to address volume uncertainty in an area such as load-related capex. In principle these would involve flexing an ex ante baseline allowance for investment related revenue, up or down, dependent on an agreed set of assumptions.

For example, this might include:

- a reinforcement revenue driver (for churn/network hot spots)
- a connections revenue driver
- a driver for replacement of Rising Mains

We will continue to support the industry-working group to develop the most appropriate revenue drivers,

Price uncertainty

We believe that risk sharing would offer the best balance of protection for customers and shareholders and propose that:

- Base allowed revenue should be set on the best available independent forecast of increases in input costs
- Triggers should be set, outside which indexation would apply and;

‘True-up’ should be undertaken at the beginning of the next price control period to take account of:

- deviations from movements in the artificial index to actual changes in input prices;
- changes in the mix of expenditure by DNOs through the price control period; and
- inevitable lags between the timing of the expenditure, publication of the index and, subsequently, adjustment to allowed revenue.

In the absence of a ready-made index of costs affecting networks businesses, we propose that one is calculated using pre-determined weights applied to independently published relevant cost and price indices. These weights should reflect the underlying proportions of the materials/labour/contractor components of investment expenditure by DNOs in a base year.

A joint Ofgem / industry working group should be established to develop the most appropriate index of input prices.

DPCR4 ESQCR Reopener

The re-opener mechanism in DPCR4 for ESQCR should be retained as a generic mechanism for changes to legislation / mandatory obligations that lead to a material change in the costs that DNOs face. This could for example apply to the Rising Mains programme that we have incorporated within our submission in the interests of public safety.

4.3.2 Equalising incentives

It is essential that potential interactions, including those with the IQI mechanism, RAV value and, hence, depreciation charges, financial ratios and financeability are fully taken into account.

In principle, we support equalisation of incentives for opex and capex.

The simplest approach would appear to be to capitalise the same percentage of all expenditure into the RAV, as this would remove boundary issues. However, the percentage of expenditure, which is capitalised, would be critical. The value of the RAV is a fundamental component of the regulatory regime and is widely used by investors, analysts and financial commentators. The value of the RAV itself must not become distorted.

It is essential that potential interactions, including those with the IQI mechanism, RAV value and, hence, depreciation charges, financial ratios and financeability are fully taken into account.

4.3.3 Information Quality Incentives (IQI)

It is essential that DNOs are allowed to revise their submissions once the IQI mechanism and output measure assessment framework have been published.

Given the requirement for output measures, the complexity involved and the various starting positions of DNOs it is appropriate to have a single-tier IQI mechanism for DPCR5.

This single-tier IQI mechanism should distinguish between inefficiencies in DNOs capital plans and differences in network policies between DNOs.

Before considering what capex should be included in the IQI mechanism we would anticipate that Ofgem will apply a filter on items that signify a different policy to ensure that investment plans are evaluated on a like-for-like basis. For example, as a Company we recognise that there is a significant safety issue in the UK surrounding rising mains and mural wiring, we have advanced a plan to replace c.10% of these assets within our franchise areas during DPCR5⁸ in the interests of public safety, but we also recognise that not every company may have detected this as a problem as yet. We do not believe that incorporation of this programme, essentially proactive management of a public safety issue, should leave us disadvantaged in the IQI mechanism.

We would make the following comments on the detail of the scheme:

⁸ We propose a 10 year programme to renew 20% of these assets

- Benchmarking of opex provides the regulator with full information on DNOs' opex performance so there is no need to extend IQI to include opex
- We would question the inclusion of Load Related capex within the IQI mechanism in the event that we develop revenue drivers to adjust the revenue allowances based on volumes of activity.
- Differential IQI mechanisms based on robustness of output measures must be fully justified and take into account the different starting positions of DNOs.
- The IQI should avoid penalising DNOs, which are subject to inevitable uncertainty, especially in a period where macroeconomic conditions and forecasts have shifted markedly, over the last few months (e.g. the depth and duration of the recession is unknown).

The primary purpose of IQI was to encourage accurate forecasts from DNOs and we do not accept that perceived risk aversion of management distorts the IQI mechanism in the way that has been suggested. No analysis has been published to support this unfounded assertion. We are concerned that tilting the IQI matrix may have unexpected and potentially undesirable consequences. In any case, there is no reliable way of quantifying the degree of risk aversion, if any, and so it would not be possible to calculate the optimal degree of tilt. Consequently, there is a severe risk that the matrix is tilted too much.

Finally, Ofgem must allow DNOs the opportunity to revise their forecasts after the IQI matrix has been published; otherwise, the IQI will be totally ineffective. We note that Ofwat published their version of the IQI matrix on 19 December 2008 and are allowing water companies adequate time to review their FBPQ responses prior to submission, whilst DNOs have had to prepare their detailed FBPQs without knowledge of Ofgem's IQI matrix.

4.3.4 Output measures

We welcome Ofgem's proposals that the assessment of a DNOs delivery of its commitments to output measures will not be formulaic in nature, but will enable Ofgem and the DNOs to factor in the impact of emergent issues such as plant type faults or new legal obligations

We welcome Ofgem's proposals that the assessment of a DNOs delivery of its commitments to output measures will not be formulaic in nature, but will enable Ofgem and the DNOs to factor in the impact of emergent issues such as plant type faults or new legal obligations that emerge during the course of DPCR5.

It is important that Ofgem consider DNO's proposals for output measures pragmatically, including an assessment of the relative starting positions of DNOs.

If Ofgem decide that a two-tier IQI mechanism is appropriate then DNOs should be afforded a further opportunity for submissions following publication of clearer guidelines on ‘robustness’ and the detail of the IQI mechanism.

Common output measures may be achieved in relation to some DNO activities, however it is probable that differences in data collected (current and historic) will limit this possibility.

4.3.5 Comparative analysis

Benchmarking of operating costs is appropriate, however this needs to be carefully managed to ensure this delivers accurate and fair results.

We agree that benchmarking of operating costs is appropriate and that the range of alternative techniques mentioned should in theory be capable of achieving this accurately and fairly.

Given the lack of detail on the actual approach that will be used contained in the paper it is not possible at this stage to comment on Ofgem’s approach in any meaningful way. We look forward to discussions in the lead up to the publication of the Methodology and Cost Assessment Document in April/May where we would anticipate that the substance of Ofgem’s approach will emerge.

4.3.6 Assessment of investment requirements

We support Ofgem’s approach focussing on load “hotspots” and welcome further work on the load related model. We are also supportive of Ofgem’s approach on non-load provided that this is subject to adequate expert review.

Load Related

We support Ofgem’s approach to deal with load “hotspots” as being far more suitable for consideration of reinforcement requirements. We would welcome further discussion with Ofgem, either directly, or through an ENA working group, on the effective application of the load related model to ensure it accurately captures the required investment drivers.

We believe that the LV connections should be treated as an excluded service given the level of competition being seen in our area.

We also agree that a revenue driver is appropriate for the larger schemes and welcome further discussion on the development of mechanisms in this area.

Non-Load Related

We support Ofgem’s approach to the assessment of non-load related investment provided that we are given adequate opportunity to review the assessment jointly with Ofgem’s experts. It is important to ensure that Ofgem’s (and the DNO) modelling assumptions are aligned, and that

expert considerations of the particular condition and performance issues faced by DNOs are also addressed. At this stage we are not clear on how asset categories that cannot be effectively incorporated within the modelling process (civils, protection etc) will be captured. It is essential that these items be dealt with consistently across all companies, particularly as they may affect the outcome of the IQI mechanism. These investments can be significant and we would expect to obtain clarification on this at the start of the process.

HILP

- Our stakeholder consultation strongly supports the socialisation of the HILP costs across all customers, as this investment is considered by the government as value adding for the GDP of the UK. Following discussions with Ofgem we understand that Ofgem are reluctant to write to DECC to seek clarification on this issue and as a result the ENA will correspond. We expect that this correspondence will clarify the position going forward

Unit Costs

- We support Ofgem's work to ensure that a consistent understanding is developed for unit costs, however this work should recognise the value to customers of differing asset management approaches, and not seek to penalise DNOs for alternative asset replacement / life extension approaches.

5 Financial Issues- ensuring that electricity network companies are able to continue to attract investment against a background where successive price reviews have significantly increased the risk borne by DNO

5.1 Cost of Capital

At a time when a significant proportion of the UK asset base is reaching the end of its operational life it is crucial now, more than ever, to set a cost of capital that enables DNOs to attract and retain the funding required to meet a step change in capital expenditure levels. Given the current uncertainty due to the credit crisis we believe that further analysis of debt triggers should be undertaken.

The credit crunch has both raised the cost of debt and significantly reduced its availability. The premiums on corporate debt have widened substantially, disproportionately so below the single A grades. With RPI inflation falling rapidly, the real cost of debt will rise further. At times, the market has effectively been closed to issuance of debt with the lowest investment grades. Also, non-price conditions have tightened significantly. Although there is considerable uncertainty about the depth and length of the recession, it is unlikely that recent developments will prove transitory. It is most probable that the era of “cheap” debt is over.

Financial volatility has increased during the credit crisis and onset of recession. Measures of equity volatility (both calculated from equity movements and implied from options) have increased sharply through 2008 and remain at historically high levels. Investors have been reluctant to take-up rights issues, making it difficult to raise additional equity capital.

Against this background, we propose to undertake further analysis to assess whether debt triggers would be appropriate and, if so, how such a mechanism should be constructed and operated.

5.2 Financeability and Financial Modelling

5.2.1 Accelerated Depreciation

Accelerated depreciation remains an essential means of applying a financeability adjustment. It is well understood, predictable and transparent, and is NPV neutral thus ensuring companies have adequate cash-flows for investment and customers are protected financially.

SP Distribution and Scottish Hydro Electric Power Distribution are the last remaining DNOs to face the post vesting “cliff face”. It is crucial that the resultant, very material, shortfalls in revenues are mitigated using the same approach and specific treatment as was previously applied to all other DNOs; i.e. the accelerated depreciation of post vesting assets using an

assumed 20-year life with a 15-year catch up and that financeability tests are carried out from this baseline.

We understand Ofgem's concerns regarding depreciation rates and their long-term impacts. We believe however that in the interests of regulatory consistency the current precedent applied at DPCR4 and more recently for the Scottish companies at the TPCR should be extended for the duration of DPCR5. If that was not the case then the two Scottish companies would require a commensurate adjustment to uplift revenues in order to achieve and maintain our key financial ratios.

We recommend that a number of possible solutions are fully considered as part of Ofgem's RPI at 20 project when each DNOs RAVs and capex profiles can be modelled in detail in order to find an optimal strategy going forward. We believe that any attempt to reset depreciation rates as part of DPCR5 would introduce unnecessary complexity and uncertainty, at a time when the priority is to fund the increased investment programmes of the DNOs.

It must be recognised that resulting short term financial constraints arise from the interaction of regulatory remuneration mechanisms with investment profiles rather than from any mismanagement of companies.

Even in the absence of the cliff edge issue faced by the Scottish DNO's it should be noted that any move to lengthen regulatory asset lives would lead to financeability problems in the absence of other remedies. These alternatives may be more feasible if developed and carefully communicated externally via the RPI at 20 process.

5.2.2 Financeability

Consistent with previous price control reviews, Ofgem should continue to test proposals for consistency with credit ratings comfortably within investment grade.

The current licence obliges companies to take all appropriate steps to ensure that they maintain an investment grade issuer credit rating at all times.

With companies being faced with raising new debt to fund higher capex programmes, increasing restrictions on the availability of credit, and credit insurers reducing their cover particularly in the retail sector, it is important that Ofgem reassess its view of "comfortably within investment grade". Strong credit ratings are required in the current financial climate and we believe that companies need to be within the "A" range of credit ratings and that the floor should therefore be "A-". We believe that the current ratios themselves are fit for purpose as metrics, although we are of the view that consideration of equity based metrics such as dividend cover may also be appropriate.

We are concerned that Ofgem still do not recognise the need to consider the post-maintenance interest coverage ratio (PMICR) as a key financial ratio. For example, Fitch recently stated⁹

“Because PMICRs take into account the cash which must be spent in order to preserve the value of the RAV in calculating the amount of cash available to service interest, Fitch believes that PMICRs are the most appropriate interest coverage metric for UK regulated utilities.”

Similarly, Moody’s uses¹⁰ adjusted interest cover

“This ratio is calculated by Moody’s to measure the degree of interest cover of a regulated company after deducting from post-tax operating cash flows available to cover interest expenses the portion of the capital expenditure that is necessary to maintain the RAV constant in real terms. This is the amount of capital investment that compensates for the depreciation of the RAV (as increased or decreased by any profiling mechanisms applied in the relevant regulatory model).”

We therefore expect Ofgem to include an adjusted interest coverage ratio in its financial model and in its assessment of financeability for DPCR5.

We believe strongly that these should be tested for the duration of the price control period to ensure that they do not exhibit a deteriorating trend since such a pattern could in itself trigger a credit rating downgrade and thus make raising finance more costly. In addition we believe that these should be stress-tested for adverse shocks and that appropriate headroom should be maintained. One area that should be specifically stress tested is the implications of negative inflation on financeability.

Consistent with good regulatory practice we agree that it is important that the price control is a transparent process. In order to ensure full transparency of how the final proposals are derived we believe that it is essential that there is a transparent audit trail in the DPCR5 financial model showing how the costs are derived from the FBPQ.

5.2.3 Financial modeling

Financial modelling must use a statutory approach.

We note that the tax computation is being calculated by using regulatory cost allocations as opposed to statutory cost allocations. Corporation tax is calculated based on statutory cost allocations.

⁹ Post-maintenance Interest Coverage Ratios for UK Regulated Utilities, Fitch Ratings, 28 February 2007

¹⁰ UK Regulated Industries: Q&A on Lending against the Regulated Asset Value, Moody’s Corporate Finance, November 2007

We acknowledge that when allocating the total cost pool for the purposes of calculating regulatory revenue excluding tax these allocations will apply regulatory principles; for statutory taxation purposes these same costs in total need to be transferred back onto a basis consistent with generally accepted accounting practice as this is how the taxation authorities will deal with the actual costs when determining the cash tax liability of the regulated business. If this adjustment of costs back to generally accepted accounting practice is not adopted then the Distribution companies will not be receiving the correct tax allowance in the final price control settlement.

5.3 Treatment of Taxation

We believe there should be a pass through mechanism or triggered reopener for material tax changes out with company's control.

Ex-post adjustments for changes in the tax regime/triggers – We agree that such changes in the tax regime, tax legislation and HMRC published guidance (such as changes to the corporation tax rates or to the rate of tax relief for capital expenditure) that are outside the control of licensees should be subject to an ex-post adjustment mechanism. This mechanism should be symmetric (i.e. both reductions and increases in the tax cost allowance should be treated equally).

The mechanism for calculating the appropriate adjustment should be included as part of the DPCR5 Final Proposals to ensure certainty for investors, consumers and licensees if this adjustment needs to be invoked.

We believe that 100% of the effect of such changes should be passed to consumers as either a benefit or an increase in charges – therefore no trigger level is needed.

Modelling of capital allowances – Consistent with good regulatory practice it is important that a consistent policy (as with all other aspects of the price control settlement) for modelling capital allowances is applied to all. We believe that the ‘DNO-specific tax pool allocation policy’ option is preferable.

5.4 Treatment of Pensions

Pension allowances should be based on DNO's assessment of their pension costs over DPCR5

We favour option 2 as outlined within Appendix 10, i.e. base pension allowances on DNO's assessment of their pension costs over DPCR5, supported by work from scheme actuaries and subject to Ofgem review.

In respect of the review of the working of the pension principles we welcome the conclusion that there is no need to change the overall pension principles.

6 Process and timetable

The timetable for response to the Policy consultation is inappropriately short, and we have concerns over the timing of publication of details of the IQI scheme in relation to FBPQ submissions.

We are disappointed at the compressed timescale allowed for responses to this important paper (10 weeks inclusive of the Christmas period). Twelve weeks would still have provided Ofgem with up to 3 months to incorporate responses in the analysis to inform the May 2009 consultation paper.

The process timetable on page 105 of the paper says that draft licence modifications will be published in December 2009. Based on experience in DPCR4, It is important that this process begins much earlier and that *individuals involved in developing the incentive mechanisms are tasked with drafting the associated Licence changes*. We would like to work with other DNOs and Ofgem on draft licence modifications following the Initial Proposals.

We continue to believe that there should be an update document this September, even if there is no new information from DNOs or arising from the wider environment. In past reviews, Ofgem's own thinking has often changed significantly between the Initial and Final Proposals. We would expect a chance to examine and comment on such changes in detail. **Meetings with the DPCR5 team and the Committee of the Authority are not a substitute for this part of the process.**

We believe that the working groups and industry workshops organised by Ofgem throughout 2008 have worked effectively and believe that these should be continued throughout 2009. However, we have some concern over the undue influence of a single major Supplier who has been invited to participate in workgroups whilst other Suppliers and stakeholders have been excluded. This may be detrimental to the consultation process.